Office of Chief Counsel
Internal Revenue Service

memorandum

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RTBennett

date: AUG 29 2002

to: [redacted], International Examiner

from: Area Counsel
(Heavy Manufacturing and Transportation:Edison)

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subject: [redacted]: Dual Consolidated Loss
EIN: [redacted]
Tax Year: [redacted]
UIL: 1503.04-00

This memorandum responds to your request for assistance dated July 11, 2002. This memorandum should not be cited as precedent.

Facts.

The taxpayer [redacted] Corporation ("[redacted]") and subsidiaries filed a consolidated return for its [redacted] tax year. [redacted] is a [redacted] taxpayer. [redacted] wholly owned [redacted] Limited ("[redacted]"). [redacted] was an affiliated corporation on [redacted]'s consolidated return for the [redacted] tax year. [redacted] was incorporated in the United States but pursuant to United Kingdom law was managed and controlled in the United Kingdom. During the [redacted] tax year, [redacted] was a dual resident corporation under Treas. Reg. §1.1503-2(b). For the [redacted] tax year, [redacted] had a net operating loss of $[redacted]. According to [redacted], the loss resulted almost exclusively from a worthless stock deduction for failed exploration ventures in the [redacted] and [redacted]. According to [redacted], [redacted] has not been a member of any group or consortium of corporations in the U.K. at any time.

With its consolidated return for the [redacted] tax year, [redacted] filed a "(g)(2) agreement" for [redacted] pursuant to Treas. Reg. §1.1503-2(g)(2). As a result, [redacted] utilized the net operating loss of [redacted] to offset the income of the other affiliates on its U.S. consolidated return for the [redacted] tax year.

By letter dated [redacted], [redacted] informed the examination

team that it wished to disclose the issue of [redacted]'s net operating loss pursuant to Rev. Proc. 94-69. In the letter, [redacted] offered two explanations why [redacted]'s loss could be utilized to offset the affiliated group's income on the U.S. return. First, [redacted]

At a meeting with [redacted]'s director of compliance and audit on [redacted], the director informed the examination team that [redacted]

The examination team has requested our opinion regarding [redacted]'s positions.

Discussion.

A "dual resident corporation" is a domestic corporation that is subject to the income tax of a foreign country on its worldwide income or on a residence basis. Treas. Reg. §1.1503-2(c)(2). If a dual resident corporation is a resident of a foreign country in which the law permits the losses of such corporation to be used to offset the income of other commonly controlled resident corporations then the dual resident corporation (absent section 1503(d) discussed below) might be able to use a single economic loss to offset two separate items of income, i.e. separately offset the income of its affiliates which are residents in the United States and again offset the income of its affiliates which are residents only in the foreign country. This practice is referred to as "double dipping." British Car Auctions, Inc. v. United States, 35 Fed Cl. 123, 125 (1996), aff'd per curiam, 116 F.3d 1497 (Fed Cir. 1997).

The United States Congress addressed the practice of double dipping in the Tax Reform Act of 1986 with the enactment of section 1503(d).[1] Section 1503(d)(1) states:

"The dual consolidated loss for any taxable year of

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[1]Unless otherwise indicated, all section references denote the Internal Revenue Service of 1986 as in effect for the years in issue.

> any corporation shall not be allowed to reduce the taxable income of any other member of the affiliated group for the taxable year or any other taxable year."

A dual consolidated loss is "any net operating loss of a domestic corporation which is subject to an income tax of a foreign country on its income without regard to whether such income is from sources in or outside of such foreign country, or is subject to such a tax on a residence basis." Section 1503(d)(2)(A).

A dual consolidated loss does not include a net operating loss incurred by a dual resident corporation in a foreign country whose income tax laws (1) do not permit the dual resident corporation to use its losses, expenses or deductions to offset the income of any other person that is recognized in the same taxable year in which the losses, expenses or deductions are incurred ("stand alone" test) and (2) do not permit the losses, expenses or deductions of the dual resident corporation to be carried over or back to be used by any means, to offset the income of any other person in other taxable years ("carry over" test). Treas. Reg. §1.1503-2(c)(5)(ii)(A)(1) and (2). Under the carry over test, the taxpayer bears the burden of proving that no other person could possibly use the losses to offset income at any other time. The exception rarely applies. T.D. 8434, 1992-2 C.B. 240, 241.

The regulations contain an anti-"mirror legislation" provision. Treas. Reg. §1.1503-2(c)(15)(iv). This generally provides that where the income tax laws of a foreign country deny the use of losses, expenses, or deductions of a dual resident corporation to offset the income of another person because the dual resident corporation is also subject to income taxation by another country on its worldwide or residence basis ("mirror legislation"), the dual resident corporation shall be treated as if it actually had offset its dual consolidated loss against the income of another person in such foreign country. Id. The validity of the anti-mirror legislation was confirmed in British Car, 35 Fed. Cl. at 133.

Shortly after the enactment of section 1503(d) in 1986, the United Kingdom enacted it own dual consolidated loss rules. These rules are contained within the U.K. Income and Corporation Tax Act ("ICTA") at section 404. Effective for the 1987 tax year, under United Kingdom law,

> Notwithstanding any other provision of this Chapter, no loss or other amount shall be available for set off by way of group relief in accordance with

> section 403 if, in the material accounting period of the company which would otherwise be the surrendering company, that company is for purposes of this section a dual resident investing company. ICTA §404.[2]

This may have the effect of the loss being disallowed in both countries. British Car, 35 Fed. Cl. at 130. A taxpayer may not rely solely on a foreign country's mirror legislation to prove that its losses are not dual consolidated losses. Id..

The regulations under section 1503 provide two means by which the taxpayer can utilize a dual consolidated loss. First, a taxpayer may use a dual consolidate loss to offset the income of affiliated domestic corporations if it files an agreement with its tax return stating that it will not use the dual consolidated loss to offset the income of another person under foreign law. Treas. Reg. §1.1503-2(g)(2). However, a taxpayer can not utilize this exception if the foreign country at issue has enacted its own mirror legislation which applies to such taxpayer. British Car, 135 Fed. Cl. at 126, n.1; Treas. Reg. §1.1503-2(c)(16), ex. 5. Second, a taxpayer may avoid the dual consolidated loss rules if the United States and the foreign country have entered into a bilateral agreement permitting it. Treas. Reg. §1.1503-2(g)(1). The United States has not entered into any such agreement with any country to date.

A dual resident corporation may utilize its own loss, even a dual consolidated loss, to offset its own income. The dual resident corporation may carry the loss forward or back for use in other taxable years as a separate net operating loss which is treated as a loss incurred by the dual resident corporation in a separate return limitation year. Treas. Reg. §1.1503-2(d)(2)(i). The loss is subject to the limitations of Treas. Reg. §§1.1502-21A(c) or 1.1502-21(c) as appropriate. Id..

In our case, [redacted] is a domestic corporation that is managed and controlled, under [redacted] law, in the [redacted]. A corporation in the [redacted] is taxed on a residence basis. Therefore, [redacted] is dual resident corporation. Treas. Reg. §1.1503-2(c)(2). The net operating loss incurred by [redacted] in tax year [redacted] is a dual consolidated loss. Section 1503(d)(2)(A).

In its [redacted] letter, [redacted] made two arguments why it may utilize the loss of [redacted] in [redacted] to offset the income of its

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[2]Unless otherwise indicated, all references to the "ICTA" denote the Income and Corporation Tax Act of 1988 as in effect for the years in issue.

U.S. group. Even though [redacted] appears to have abandoned these arguments, we will very briefly explain why we feel the arguments are presently not meritorious.

In its [redacted] letter, [redacted] argued that the U.K.'s mirror legislation did not apply to [redacted] because [redacted] was not in a loss position in the U.K. in [redacted]. Presumably, [redacted] would then argue that it appropriately filed a (g)(2) agreement with its [redacted] return. The fact that [redacted] was not in a loss position in the U.K. in [redacted] has no bearing on the application of the anti-mirror rule of Treas. Reg. §1.1503-2(c)(15)(iv). The anti-mirror regulation plainly does not require that the dual resident corporation be in a loss position under the laws of the foreign country for it to apply. Treas. Reg. §1.1503-2(c)(15)(iv); see Treas. Reg. §1.1503-2(c)(16) ex. 5 (dual resident corporation subject to mirror legislation of the foreign country despite no mention of the dual resident corporation being in a loss position in the foreign country). Therefore, the taxpayer is incorrect to argue that [redacted] was not subject to the mirror legislation in the U.K. simply because [redacted] was not in a loss position in the U.K. in tax year [redacted]. Therefore, the loss is deemed to have been used in the U.K. and [redacted] is prohibited from filing a (g)(2) agreement. Treas. Reg. §1.1503-2(c)(15)(iv).

[redacted] also argued in its letter that the U.K. does not recognize a worthless stock deduction and therefore the loss could never be used by any other person by any means to offset income in any other taxable year under U.K. law. Here, [redacted] argues that [redacted]'s loss is not a dual consolidated loss because it meets the two prong exception to the definition of a dual consolidated loss under Treas. Reg. §1.1503-2(c)(5). [redacted] appears to satisfy the "stand alone" test since it was not part of any group or consortium in the U.K. in the year of the loss. Treas. Reg. §1.1503-2(c)(5)(ii)(A)(1). [redacted] argues that [redacted] also satisfies the "carry over" test because U.K. law does not recognize a worthless stock deduction.

The burden of proving that the carry over test is met is on the taxpayer. It is a very difficult burden and is rarely met. T.D. 8434, 1992-2 C.B. 240, 241. The burden is difficult because it requires that the taxpayer prove a negative, i.e. no other person could use the loss to offset income by any means in any other taxable year under the foreign law. As the Service has recently stated,

> "[t]he taxpayer cannot show that it meets these tests [stand alone and carryover] merely by stating conclusions. Rather, we believe that the taxpayer must present a well reasoned analysis that cites the

> specific foreign tax laws upon which it relies, together with other substantial authority that may exist, and applies those laws to the particular facts of the dual resident corporation." FSA 20022018 (February 13, 2002) 2002 TNT 102-73.[3]

The taxpayer must address all conceivable means, both direct and indirect, by which the loss may be used. Id..

In our case, [redacted] has merely stated that the [redacted] does not recognize a worthless stock deduction. Clearly, this falls short of meeting the lofty burden of proof imposed under the carry over test. In the event that [redacted] proceeds with this argument and submits a more thorough analysis of U.K. law, we encourage the examination team to contact our office for further advice.

As we understand the issue, [redacted] has most recently argued that while [redacted]'s loss from tax year [redacted] should not have been utilized by the U.S. group to offset the affiliated corporations' income on the [redacted] return (i.e. the (g)(2) agreement should not have been filed), [redacted] can carry forward its own loss to offset its own income in the [redacted] tax year. Our office concludes that [redacted] is correct on this point.

As stated above, a dual resident corporation may utilize its own loss, even a dual consolidated loss, to offset its own income. The dual resident corporation may carry the loss forward or back for use in other taxable years as a separate net operating loss which is treated as a loss incurred by the dual resident corporation in a separate return limitation year. Treas. Reg. §1.1503-2(d)(2)(i). The loss is subject to the limitations of Treas. Reg. §1.1502-21A(c) or §1.1502-21(c) as appropriate. Id.. Therefore, [redacted] may carryforward the loss from tax year [redacted] to tax year [redacted]. We recommend that the examination team ensure that [redacted] appropriately carries forward the loss under Treas. Reg. §1.1502-21(c).

Please be advised that this advisory is subject to post review by our National Office. If you have any questions, please contact attorney Robert T. Bennett of our office at (973) 645-3244.

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[3]As Chief Counsel Advice, Field Service Advice can not be cited or used as precedent. Section 6110(b)(1) and (k)(3).

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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